

Who Dares Oppose a Boom?

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Systemic Risk: Financial Reform—Too Little or Too Much, On-Track or Off-Course?

By David J. Merkel, CFA
Principal, Aleph Investments, LLC

Disclaimer

Everything written here is opinion. You should not believe it as fact. But, knowing that there are many gullible people in this world, who take opinions as facts, I reiterate that in economics, there are few settled truths. After all, we are studying people and societies, which are given to change. It would be foolish to assume there is any degree of precision in a discipline where true experiments can't be done.

The author has done his best to be honest, accurate, and yet, pointed. After all, what interest is there in someone who cannot articulate a point of view? To that end, consider the arguments of the author. He thinks they are true. What do you think?

The Challenge

The U.S. Congress recently passed the most sweeping financial reform measure since the Great Depression. The purpose of this legislation is to prevent the risky behavior and decision-making that led to the financial crisis, and to prevent future crises.

- *Does this legislation solve the problems of the past?*
- *Are there other significant issues not addressed?*
- *Does this legislation cause other concerns?*
- *In reflecting on the events of the last two years, is it possible to effectively develop early warning indicators that trigger intervention in advance of a complete collapse of an entire financial system or market?*
- *Does it make sense to have a chief risk officer of, say, the United States of America, whose role it would be to manage/mitigate this risk?*

The Choice



Economics or Politics?

- Economics: Did regulators not have sufficient latitude and knowledge/tools to deal with the growing problems?
- Politics: Or was it a lack of willingness to address problems?

The Nature of Booms

The fool does at the end of a bull market what the wise man does at its beginning.

Wall Street Aphorism

Booms Usually Start Well

- Equity finance
- High return on Assets
- Took some work to make the decision



Success Breeds Imitation

- Opportunity becomes better known
- Deals are lower quality
- ROA is slipping
- Financing more available



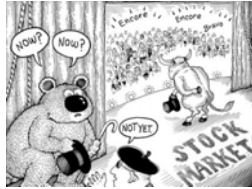
Can Become Faddish



- Opportunistic capital shows up
- Drives up prices / Short term finance
- Momentum psychology builds
- "Everyone is doing it"

Tend to Last Longer Than Reasonable

- There are naysayers, but they are derided as mindless bears trying to scare a fundamentally sound market for financial gain.
- Bull cycles in credit take a long time to play out.
- Leverage rises, spreads grind tighter, complexity increases.



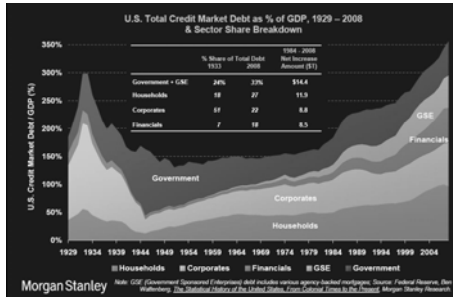
Conditions at the End of the Boom

- Indebtedness high
- Short-term finance prevalent
- ROAs are low
- Opportunistic capital fully deployed
- Long-term players w/flexibility are gone
- Players have to feed the asset to keep it.
- Average player IQ is low.

Can You Spot an Unsustainable Boom?



Spot the Large Debt Increases



Stop the Large Debt Increases?

- Easy to SPOT; easy to POST; hard to STOP.
- Disbelief
- Derision
- Political-connectedness
- Regulatory capture / Revolving door
- Near the end of a credit cycle loss statistics typically look good.
- Economists think debt is neutral
- Favorable trend helps governments in short-run

Who Dares Oppose a Boom?

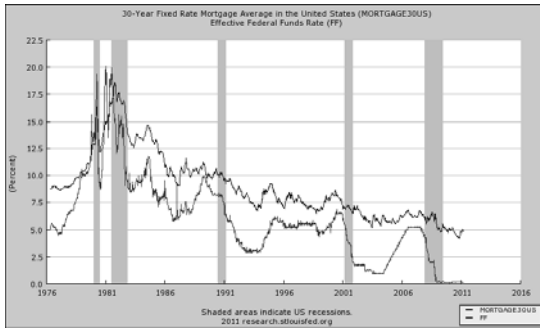
- Hedge Funds
- Value Investors
- Leftists
- Cranks
- No one with any real political power ever opposes a boom



Quis custodiet ipsos custodes?



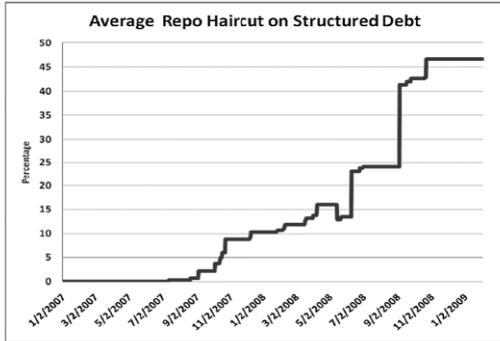
Can Systemic Risk be Controlled?



Can Systemic Risk be Controlled?



Can Systemic Risk be Controlled?



Can Systemic Risk be Controlled?



Summary

- Politically difficult to stop booms; everybody loves them while they are going.
- Regulators had more than enough tools to deal with credit and leverage issues. They did not use them. Why will they use the new tools next time?
- Let the government focus on underlying regulatory capture and try to prevent it.
- Let the banking regulators set real leverage, ALM, counterparty, and other limits for banks.
- Who will limit the Fed and its monetary policy? When will they realize that systemic risk is largely their creation?
- Do we have the backbone to fire regulators that have failed?
- When will we as a culture accept that smooth permanent prosperity is not possible, and toss out the politicians that promise prosperity? We should know they can't deliver.

Contact Data

David J. Merkel, CFA
david.merkel@gmail.com
<http://alephblog.com>

Aleph Investments, LLC
aleph.investments@gmail.com
410-750-7894
